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April 25, 1980

No. 80/69

TO COUNTY ASSESSORS:

BUSINESS INVENTORY EXEMPTION

Attached to this letter are questions and answers pertinent to the business inventory exemption. The questions have been categorized for easy reference and numbered consecutively within each category.

The major categories are as follows:

- A. Administrative
- B. Manufacturing
- C. Retailing
- D. Professional and Service Enterprises
- E. Agricultural Enterprises
- F. Property Held for Lease

We last published a list of questions and answers on June 5, 1975. Questions and answers that were not on that list are noted with the word "NEW" to the left of the question. In some instances the answers to certain questions have been revised. These revisions are indicated with the word "REVISED" to the left of the answer.

The passage of Assembly Bill 66 (Statutes 1979, Chapter 1150) eliminates the assessment of business inventories as of the 1980 lien date. The 100-percent exemption makes a proper description of business inventory even more important today than in the past.

We hope this material will help promote uniformity of administration. We will appreciate your comments and submission of additional questions.

Sincerely

Verne Walton, Chief
Assessment Standards Division

VW:do
Attachments

BUSINESS INVENTORY EXEMPTION

QUESTIONS AND ANSWERS

A. ADMINISTRATIVE

1. What is the nature of the business inventory exemption?

Answer: It exempts from property taxation a designated percentage of the assessed value of personal property which qualifies as inventory under Board Rule 133. The percentage for the 1974-75 thru 1979-80 fiscal years is 50 percent. Beginning 1980-81, such personal property is fully exempt from property taxation.

2. Does the business inventory exemption apply to escaped property enrolled under Sections 531.3, 531.4, and 531.5?

Answer: Not for property escaping assessment for 1974-75 fiscal year and prior. However, for 1975-76 thru 1979-80 fiscal years the exemption is only denied to escapes to which the penalty in Section 504 is applied.

NEW

3. Upon auditing a taxpayer's 1978-79 return, you find he has willfully underreported machinery and equipment to which the penalty in Section 504 is applied. You also find that inventory was underreported, but not willfully. Would the escaped inventory be eligible for the business inventory exemption?

Answer: Yes. For the 1975-76 thru the 1979-80 fiscal years the exemption is denied only if the penalty under Section 504 is applied to the escaped inventory. Application of the Section 504 penalty to the machinery and equipment escape would have no bearing on the inventory escape.

REVISED

4. For years prior to 1980-81, if a taxpayer does not return a property statement to the assessor when requested by the assessor and the assessor makes an assessment pursuant to Section 501 of the Revenue and Taxation Code to which the penalty in Section 463 applies, does the business inventory exemption apply to the business inventories so assessed?

Answer: Yes. Of course for 1980-81 an assessment pursuant to Section 501 would not contain a value for business inventories.

- NEW 10. Does inventory erroneously reported as supplies qualify for the business inventory exemption once it is discovered?

Answer: Yes.

B. MANUFACTURING

1. Do manufacturing supplies qualify for the business inventory exemption?

Answer: Manufacturing supplies, such as nuts, bolts, and screws, that will be incorporated in a product that is to be sold are eligible. Supplies, such as drill bits, that are not physically incorporated into the product are not eligible. Also not eligible are catalysts used to accelerate chemical or physical reaction but which are not intentionally incorporated into the product.

2. Does machinery and equipment that is held for use qualify for the business inventory exemption?

Answer: No.

3. May dies, patterns, jigs, or tools held for use qualify for the business inventory exemption?

Answer: No.

4. Are unmined minerals, such as iron ore, subject to the business inventory exemption?

Answer: No. The exemption applies only to personal property.

5. Are parts held by manufacturers so as to perform warranty service on products they sell eligible for the business inventory exemption?

Answer: Yes. Although the parts are not sold outright, they are held for repair of products that are sold. The selling prices of the products will include amounts to cover normal warranty repairs.

- REVISED 6. Is sand and gravel held by a licensed contractor for incorporation into a bridge or road bed eligible for the business inventory exemption?

4. Do consigned goods that are held for sale qualify for the business inventory exemption?

Answer: Yes.

5. Is farm or construction equipment, that was previously used by a farmer or contractor, eligible for the business inventory exemption once it is consigned to an auctioneer for sale?

Answer: Yes, the equipment is held for sale by the auctioneer whose normal business is selling such goods.

6. Farm or construction equipment is held and advertised by a farmer or contractor for sale as a means of disposing of old or excess equipment. Is such equipment eligible for the business inventory exemption?

Answer: No, it is not held for sale in the normal course of business. Their business is farming or contracting, not selling used equipment.

7. Are trading stamps in the hands of the trading stamp company eligible for the business inventory exemption?

Answer: Yes, they constitute the transfer of property during the rendition of a service.^{1/}

8. Are trading stamps held by a retailer for distribution with the sale of his goods eligible for the business inventory exemption?

Answer: No, title to the stamps remains with the trading stamp company; therefore, the retailer cannot "sell" the stamps. They should be treated as a supply item in the retailer's hands.^{1/}

9. Are display items eligible for the business inventory exemption?

^{1/} Value of trading stamps for property tax purposes, whether in the hands of the trading stamp company or the retailer, is the cost of printing, perforation, adding adhesive, and the printer's profit. This was spelled out in an Assessors' Letter dated November 22, 1971.

Answer: No. Property Tax Rule 133(b)(2) excludes personal property from the exemption if the assessment ratio or the tax rate is at a different proportion to value than that applied to real property. Aircraft are subject to an in-lieu tax based upon a 100-percent assessment ratio.

- NEW 16. A retailer selling office machines and equipment periodically removes equipment from inventory for use as his office equipment. The equipment is used for a period of time then returned to inventory for sale. The retailer insists the equipment is still for sale even though it is in use and has been removed from display.

Is the equipment eligible for the business inventory exemption while being used as office equipment by the retailer?

Answer: No. The equipment is in use at the consumer level and is not being displayed or otherwise offered for sale.

D. PROFESSIONAL AND SERVICE ENTERPRISES

- NEW 1. Goods transferred in the rendition of a professional service are not eligible for the business inventory exemption, while goods transferred in the rendition of a nonprofessional service are eligible. What criteria determines whether a service is professional or non-professional?

Answer: Property Tax Rule 133(c) gives examples of medicine, law, architecture, or accountancy as professional services. It lists dry cleaners, beauty shop operators, and swimming pool service companies as examples of non-professional services. There are, of course, many services in between that are more difficult to assign to one group or the other.

Following are criteria courts have used to distinguish between a profession or professional service and a non-professional service or enterprise.

A profession is a vocation where the labor and skill is predominantly mental or intellectual, rather than physical or manual. A profession requires knowledge of an advanced

6. An accountant maintains a stock of accounting books which he passes on to his clients as a part of his service. He has a retailer's permit. Do the books qualify as business inventories?

Answer: No. However, if the accountant regularly bills clients for the books as a separate item in addition to his services, the books would qualify for the exemption.

7. Are clothes hangers and plastic bags held by dry cleaners subject to the business inventory exemption?

Answer: Yes, because they are delivered to customers regularly as part of the non-professional service performed.

8. Are chlorine tablets held in storage by a swimming pool service company business inventories?

Answer: Yes, because they are delivered to customers as an item regularly included in the non-professional service.

9. Are replacement parts held in an auto repair shop business inventories?

Answer: Yes.

10. Are television tubes and electrical parts held in a television repairman's kit subject to the business inventory exemption?

Answer: Yes.

11. Some companies, such as airlines and bus companies, stock spare parts for use in repairing both their own equipment and equipment belonging to others. Do all or any portion of these parts qualify as business inventories?

Answer: Yes, if the owner segregates the portion of these inventories held for sale (used to repair the equipment of others) on their records and maintains a supply of such goods for immediate sale and delivery at prices which are both realistic and competitive.

- REVISED 3. Is baled cotton included in business inventories prior to July 1, 1980?

Answer: No, its tax rate is at a different proportion to value than that applied to real property. (See C15.) Effective July 1, 1980, the statutes setting the tax rate on baled cotton are repealed. Thus, baled cotton reverts back into a general property category. For the 1981 and subsequent lien dates baled cotton will either be taxed the same as other personal property or exempt as business inventory depending on the circumstances involved.

4. Is farm equipment held for sale by the farmer who owns it subject to the business inventory exemption?

Answer: No, isolated sales of used equipment do not constitute a business. However, see C5 regarding equipment consigned to an auctioneer.

5. Are unharvested oranges subject to the business inventory exemption?

Answer: No, unharvested oranges qualify as growing crops. Growing crops are not eligible for the exemption; they are however, exempt as growing crops.

- REVISED 6. Do seeds held by a farmer for planting qualify as business inventories?

Answer: Yes, if they are to be used in the production of a crop grown primarily for sale.

7. Are seeds eligible for the business inventory exemption if held for planting in order to produce a crop that will be used as feed for eligible animals?

Answer: No.

- NEW 8. Property Tax Rule 133(e)(2) provides that "seed to be used in the production of a crop which is to be held primarily for sale," is eligible for the business inventory exemption. For purposes of the exemption, what does the term "seed" include?

16. Are farm animals held for breeding purposes subject to the business inventory exemption?

Answer: Yes, if their offspring are normally used as food for human consumption or for the production of fiber useful to man.

- NEW 17. Are stallions and mares held for the production of offspring eligible for the business inventory exemption as "animals held for the breeding of livestock"?

Answer: No. Those qualifying for exemption as "animals held for the breeding of livestock" are animals that produce offspring that will be used for food or fiber for human use or consumption.

18. Are show horses and race horses subject to the business inventory exemption?

Answer: No. Race horses are ineligible since they are subject to an in-lieu fee. Show horses would be eligible only if held for sale in the normal course of business of the owner.

19. Are farm animals that are used to work the farm subject to the business inventory exemption?

Answer: Yes, if they are used in the raising of crops which are held for sale, or for the feeding, breeding, or management of livestock.

20. Are pack animals used by a guide to pack campers into the mountains eligible for the business inventory exemption?

Answer: No. However, if the pack animals are held for lease to campers, are directly under the campers' control, and are not otherwise used by their owner, they would be eligible.

21. Are plants grown by nurseries for the production of cut-flowers eligible for the business inventory exemption?

Answer: No, the plants are not held for sale. Only their products (the flowers) are sold.

- NEW 22. Is felled timber lying in the woods on the lien date eligible for the business inventory exemption if it is to be sold as either logs or finished products?

4. Are vending machines held in the owner's hands that are normally placed on site to dispense food eligible for the business inventory exemption?

Answer: No, unless the machines are held for rent. Placing them on site does not constitute a rental. Sharing of the receipts with the site owner constitutes payment for use of the site.

- REVISED 5. Are coin-operated pool tables, shuffle boards, etc., eligible for the business inventory exemption?

Answer: Yes, but only when held for sale or rent. Most vending machine transactions involve a machine owner paying a site owner for the use of the site, rather than the site owner paying the vendor a rental for the equipment. Only in the later instance would a "rental" of the equipment occur.

6. Are items eligible for the business inventory exemption if held for lease by a person who has himself leased the items from someone else?

Answer: Yes. The determining factor is the status of the items on the lien date; i.e., they are held for lease in the normal course of business.

7. A taxpayer is in the business of leasing property to others. He purchases some of the items he holds for lease and self-constructs others. Are the items in the process of being constructed eligible for the business inventory exemption?

Answer: Yes. Raw material, work in process, or finished goods are all eligible if they will become part of or are themselves items of personalty held for sale or lease.

- REVISED 8. Are boats held for rental purposes eligible for the business inventory exemption if, on the lien date, the rental operation is closed for the winter?

Answer: Yes. Even though the boats are not "held for rent" on the lien date due to the operations being closed for the winter, they are still eligible for the exemption since they are held for rent in the normal course of business. (See F1.)

- NEW 15. Are the supplies of motor fuels held by an equipment operator eligible for the business inventory exemption where the fuels are consumed by the operator's equipment during the performance of a job?

Answer: No. The fuels are neither supplied to the customer nor are they delivered to the customer in the performance of a non-professional service.



STATE BOARD OF EQUALIZATION

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November 8, 1995

Attn:

Dear Mr.

This is in response to your letter of March 8, 1995 concerning the business inventory exemption as discussed in our letter to assessors 80/69 dated April 25, 1980 (copy enclosed). I apologize for the delay in responding; other matters requiring our attention have resulted in an unfortunate backlog of correspondence.

You requested that we clarify in writing our response to question F(1) of letter to assessors 80/69. Question and answer to F(1). "Property Held for Lease" reads:

1. "Are goods held for lease eligible for the business inventory exemption?"

Answer: "Yes, if the property is not actually out on lease on the lien date and is not used by or intended to be used by the lessor for some purpose other than the prospective sale or lease of that property. Also, the property while on lease must be removed from the premises of the lessor and under the control of the lessee."

The answer provides that "the property while on lease must be removed from the premises of the lessor and under the control of the lessee." You are requesting clarification on whether the removal of the property from the premises is a required element for such property to be considered leased equipment, and thus, whether property held for lease under those circumstances is eligible for the business inventory exemption.

Our response to the first part of your question is no. The removal of the leased property from the premises is not a required element for such property to be considered as leased equipment. The crucial element in whether the property is under the control of the lessee.

November 8, 1995

In response to question F(12) of the same letter to assessors, we emphasized that the key element for a property to be considered leased equipment is that the lessee has control over the property during the period of the lease which was also part of our response in F(1). It is clear from F(12) that the issue of control is crucial to the determination of whether a property is leased or not. The removal of the property from the lessor's premises is one of the factors in determining whether equipment is actually leased, but the compelling requirement is the control factor.

Once the determination of control is made, then the issue of whether property held for lease is eligible for the business inventory exemption is addressed by F(1) of letter to assessor 80/69.

The views expressed in this letter are, of course, only advisory in nature. They are not binding upon the assessor of any country. You may wish to consult the appropriate assessor in order to confirm that the described property will be assessed in a manner consistent with the conclusions stated above.

Sincerely,



Charles G. Knudsen
Principal Property Appraiser
Assessment Standards Division

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